

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION**

CRAIG COMB and ROBERTA TOHER, on behalf
of themselves and all others similarly situated and
on behalf of the general public of the United States,

Plaintiffs,

v.

PAYPAL, INC.,

Defendant.

JEFFREY RESNICK, on behalf of himself and all
others similarly situated and on behalf of the
general public of the United States,

Plaintiffs,

v.

PAYPAL, INC.,

Defendant.

Case Number C-02-1227 JF (PVT)
C-02-2777 JF (PVT)

ORDER DENYING MOTIONS TO
COMPEL INDIVIDUAL
ARBITRATION

[Docket No. 23, 5]

Plaintiffs seek injunctive relief and related remedies on behalf of a purported nationwide class for alleged violations of state and federal law by Defendant PayPal, Inc. ("PayPal"). PayPal moves to compel individual arbitration pursuant to the arbitration clause contained in its standard User Agreement and the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1, et seq. The Court has read and considered the moving, responding and supplemental papers as well as the oral arguments presented by counsel on August 12, 2002. For the reasons set forth below, the

1 motions will be denied.¹

2 I. BACKGROUND

3 A. Customer Complaints

4 PayPal is an online payment service that allows a business or private individual to send
5 and receive payments via the Internet. A PayPal account holder sends money by informing
6 Paypal of the intended recipient's e-mail address and the amount to be sent and by designating a
7 funding source such as a credit card, bank account or separate PayPal account. PayPal accesses
8 the funds and immediately makes them available to the intended recipient. If an intended
9 recipient does not have a PayPal account, the recipient must open an account to access the
10 payment by following a link that is included in the payment notification e-mail. PayPal generates
11 revenues from transaction fees and the interest it derives from holding funds until they are sent.

12 As of January 1, 2001, approximately 10,000 account holders had registered with PayPal.
13 PayPal thereafter experienced a sudden and dramatic increase in its popularity, attracting one
14 million customers over the next five months and 10.6 million accounts (of which 8.5 million
15 were held by private individuals) by September 30, 2001. Currently, PayPal provides services to
16 twelve million accounts, and approximately 18,000 new accounts are opened each day. Plaintiffs
17 allege that while PayPal has experienced a seven-fold increase in revenues and a thirteen-fold
18 increase in users, it only has doubled the number of service representatives available to address
19 customer concerns.

20 Plaintiffs contend that because PayPal's customer base has exceeded its operational
21 capacity, PayPal has been and continues to be unable to maintain and manage accounts in the
22 manner required by applicable state and federal legislation. Plaintiffs allege in particular that
23 when PayPal investigates a customer's complaint of fraud, it freezes the customer's access to his
24 or her account until the investigation is completed, but at the same time keeps the account open
25 for deposits, a practice which allows PayPal to derive economic benefit from the deposits while
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27 ¹ On March 29, 2002, the Court determined that the above entitled cases are related
28 pursuant to Civil L.R. 3-12(b).

1 preventing customers from accessing even undisputed funds while the investigation is pending.
2 Plaintiffs further allege that PayPal does not provide a toll-free customer service telephone
3 number, does not effectively publish the customer service telephone number it does provide,
4 requires customers to report erroneous transactions by e-mail while not providing a specific
5 e-mail address for that purpose, requires customers to provide numerous and burdensome
6 personal documents before it undertakes an investigation, responds to e-mail inquiries with form
7 letters, refuses to provide details or explanations with respect to its investigations, and provides
8 no procedure by which a customer can appeal the results of an investigation. Plaintiffs also
9 allege that when customers *are* able to contact PayPal representatives, the representatives are
10 combative and rude, refuse to answer specific questions, hang up in the middle of phone calls,
11 provide “canned” responses to individualized problems, require customers to fax information
12 while providing inoperative fax numbers, and refuse to allow customers to speak to managers.

13 Newspaper articles have reported that disgruntled customers who have been unable to
14 contact anyone at PayPal to resolve their disputes have created their own website providing
15 consumers with difficult-to-find customer service numbers and reporting their own frustrations
16 with PayPal’s service. According to these accounts, PayPal has a backlog of over 100,000
17 unanswered customer complaints, a fact that has led the Better Business Bureau to revoke its seal
18 of approval. Plaintiffs allege that PayPal profits from its alleged acts and omissions because
19 customers either abandon their efforts to recover their money or, in cases in which funds actually
20 are returned, because it retains the interest collected on the funds it has held during the
21 investigation process.²

22 *1. Craig Comb*

23 Plaintiff Craig Comb (“Comb”), who is not a PayPal customer, alleges the following: On
24 February 15, 2002, without his knowledge, consent or authorization, PayPal removed the sums of
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26 ² PayPal objects to portions of the declarations and supporting exhibits submitted by
27 Plaintiffs Toher and Resnick as vague and ambiguous, irrelevant, improper opinion or
28 conclusion, lacking foundation, and violating the Best Evidence Rule. These objections are
overruled.

1 \$110.00 and \$450.00 from his bank account. Comb allegedly had difficulty contacting PayPal
2 with respect to the erroneous transfer and finally reached a PayPal representative on February 18,
3 2002 to report the alleged error. PayPal acknowledged the error and returned the entire \$560.00
4 to Comb's account on February 25, 2002.

5 PayPal's transfers, however, caused Comb's bank account to have insufficient funds, and
6 the bank charged Comb \$208.50 for failing to maintain his required balance. Comb contacted
7 PayPal and requested reimbursement for the insufficient fund penalty and any interest his funds
8 accrued while in PayPal's possession. PayPal allegedly refused to pay either amount, disputing
9 Comb's figures but failing to provide Comb its own figures or documentation of its investigation.

10 *2. Roberta Toher*

11 Plaintiff Roberta Toher ("Toher") alleges the following: Toher opened a PayPal account
12 sometime in 2000. PayPal failed to provide her with the name, address, and telephone number of
13 a person she should notify in the event of an unauthorized electronic transfer. On February 24,
14 2002, Toher discovered that PayPal had transferred funds from her checking account to four
15 individuals without her knowledge, consent or authorization. Toher had difficulty locating any
16 telephone number for contacting PayPal. Once she found a telephone number, which was not
17 toll-free, she was placed on hold for a lengthy period of time, and no one answered her call.
18 Toher then located PayPal's e-mail address and reported the error by e-mail.

19 On or about February 25, 2002, PayPal responded to Toher by e-mail and instructed her
20 to report the erroneous transaction by sending her complaint to either of two e-mail addresses it
21 provided. Toher sent her complaint to one e-mail address, from which it was returned
22 undeliverable, and then to the other address. She also attempted again to contact PayPal by
23 telephone. After Toher again was placed on hold for a lengthy period of time, a PayPal
24 representative instructed her to change her password and report the error by telephone to a
25 different department. Toher called that department's telephone number and spoke with a service
26 representative who informed her that he had verified that the transaction had not been initiated by
27 Toher and that PayPal would send Toher a letter explaining how to report the transaction in
28 writing. During this time, the recipients who erroneously had received the funds e-mailed Toher

1 and inquired as to the reason for the payment.

2 On or about February 27, 2002, before her complaint had been investigated or resolved,
3 PayPal informed Toher that it intended to take money from her checking account because her
4 bank had declined a different, unrelated transaction. Toher called PayPal and explained that she
5 had filed a claim with respect to the erroneous withdrawal and instructed PayPal to stop
6 removing funds from the checking account. PayPal explained that there was nothing it could do
7 to stop the latter transaction, and Toher was forced to pay a \$27.00 fee to her bank to decline all
8 subsequent electronic transactions related to PayPal. Toher contacted PayPal to request for a
9 second time the letter explaining how to report her original claim. PayPal subsequently informed
10 Toher that it would begin processing her claim once she completed and returned a notarized
11 affidavit by mail.

12 On March 6, 2002, PayPal sent Toher a series of e-mails explaining that because her bank
13 had declined its attempted transfers, PayPal intended to transfer funds from her credit card
14 account. Toher in turn closed and reopened her credit card account to prevent PayPal from
15 accessing her funds. As of the date the instant suit was filed, PayPal had not acknowledged that
16 Toher had reported an erroneous withdrawal or that an error had occurred, nor had it undertaken
17 any investigation with respect to Toher's complaint.³

18 *3. Jeffrey Resnick*

19 Plaintiff Jeffrey Resnick ("Resnick") alleges the following: Resnick registered an account
20 with PayPal and linked his e-mail address resnickjeff@hotmail.com (with two "f's") to that
21 account. He used the account to sell comic books on eBay, an Internet auction service. On
22 January 29, 2002, a third party appropriated Resnick's PayPal user name and password and
23 linked an e-mail account resnickjefff@hotmail.com (with three "f's") to Resnick's PayPal
24 account. The third party sold two Apple Computers on eBay, and the buyers deposited their

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26 ³ Although she does not so allege in her complaint, Toher claims in her responding papers
27 that PayPal still holds \$136.48 of her money and refuses to return it on the basis that she failed to
28 cooperate with PayPal's investigation. PayPal disputes Toher's allegations and provides the
results of its investigation, asserting that Toher's only legitimate claim could be for the return of
the \$27.00 she elected to pay to her bank to prevent further electronic transfers.

1 payment into the fraudulent account. When the buyers did not receive their product, they filed a
2 complaint with PayPal, which without notice or explanation then restricted Resnick's legitimate
3 account.

4 In late January or early February 2002, Resnick learned that his account had been
5 restricted and contacted PayPal to inquire as to the reason. Once informed of the circumstances,
6 Resnick explained that he had not sold the computers and stated that because the fraudulent
7 account's e-mail address contained three "f's rather than two, someone must have appropriated
8 his account information. At the time he filed the instant suit, although more than forty-five days
9 had elapsed since he informed PayPal of its error, he had not received any information or
10 documentation with respect to the status of PayPal's investigation, and PayPal had not
11 unrestricted or credited his account.⁴

12 **B. User Agreement**

13 PayPal customers open an account by completing an online application for a personal,
14 premier, or business account. A prospective customer clicks a box at the bottom of the
15 application page that reads, "[you] have read and agree to the User Agreement and [PayPal's]
16 privacy policy." A link to the text of the User Agreement is located at the bottom of the
17 application. The link need not be opened for the application to be processed. The User
18 Agreement is lengthy, consisting of twenty-five printed pages and eleven sections, each
19 containing a number of subparagraphs enumerating the parties' respective obligations and
20 duties.⁵

21 PayPal admonishes every customer to read the User Agreement carefully, informs him or
22 her that the Agreement forms a binding contract, and advises the customer to retain a copy of the
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26 ⁴ In its moving papers, PayPal rebuts Resnick's allegations of innocence and provides the
27 results of its investigation.

28 ⁵ For purposes of the present motions and unless otherwise noted, all references are to the
June 27, 2002 version of the User Agreement submitted with PayPal's moving papers.

1 User Agreement.⁶ The User Agreement is a “clickwrap contract,” formed when the customer
2 “click[s] ‘I Agree,’ ‘I Accept,’ or by submitting payment information through the Service. . . .”
3 User Agreement, ¶ 2.⁷

4 The User Agreement contains the following arbitration clause:

5 **Arbitration.** Any controversy or claim arising out of or relating to this
6 Agreement or the provision of Services shall be settled by binding arbitration in
7 accordance with the commercial arbitration rules of the American Arbitration
8 Association. Any such controversy or claim shall be arbitrated on an individual
9 basis, and shall not be consolidated in any arbitration with any claim or
10 controversy of any other party. The arbitration shall be conducted in Santa Clara
County, California, and judgment on the arbitration award may be entered in any
court having jurisdiction thereof. Either you or PayPal may seek any interim or
preliminary relief from a court of competent jurisdiction in Santa Clara County,
California necessary to protect the rights or property of you or PayPal, Inc. (or its
agents, suppliers, and subcontractors) pending the completion of arbitration.

11 User Agreement, Section II (19).

12 II. DISCUSSION

13 The FAA was enacted to overcome longstanding judicial reluctance to enforce
14 agreements to arbitrate. Bradley v. Harris Research, Inc., 275 F.3d 884, 888 (9th Cir. 2001). It
15 applies to all written contracts involving interstate or foreign commerce and provides in relevant
16 part that arbitration agreements contained within such contracts "shall be valid, irrevocable, and
17 enforceable, save upon such grounds as exist at law or in equity for the revocation of any
18 contract." 9 U.S.C. § 2. "The FAA creates a body of federal substantive law of arbitrability,
19 enforceable in both state and federal courts and pre-empting any state laws or policies to the

20 ⁶ The User Agreement begins with the following statement:

21 This User Agreement ("Agreement" or "User Agreement") is a contract between
22 you and PayPal, Inc. and applies to your use of the PayPal™ payment service and
23 any related products and services (collectively the "Service"). This Agreement
24 affects your rights and you should read it carefully. We encourage you to print the
Agreement or copy it to your computer's hard drive for your reference.

25 ⁷ ¶ 2 provides that:

26 [Y]ou agree to the terms and conditions of this Agreement, the PayPal Privacy
27 Policy, and any documents incorporated by reference. You further agree that this
28 User Agreement forms a legally binding contract between you and PayPal, and
that this Agreement constitutes "a writing signed by You" under any applicable
law or regulation.

contrary." Ticknor v. Choice Hotels Int'l, Inc., 265 F.3d 931, 936 (9th Cir. 2001) (citations and internal quotation omitted). As a result, state laws hostile to arbitration agreements have been held invalid on the ground that such laws frustrate congressional intent to place arbitration agreements on the same footing as other contracts. Bradley, 275 F.3d at 889.

State law is not entirely displaced from FAA analysis, however. It is undisputed that "generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2." Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 686 (1996). Here, the User Agreement is "governed by and interpreted under the laws of the state of California . . . [as] applied to agreements entered into and to be performed entirely within California by California residents." User Agreement, Section II (18). Because there is no dispute that the contract at issue in this case involves interstate commerce, this Court's role thus is limited to determining whether under California law (1) a valid agreement to arbitrate exists and, if so, (2) whether the agreement encompasses the dispute at issue. See Chiron Corp. v. Ortho Diagnostic Sys., Inc., 207 F.3d 1126, 1130 (9th Cir. 2000). If both of these requirements are satisfied, the FAA requires this Court to enforce the subject arbitration clause in accordance with the terms of the User Agreement. Id.

A. Agreement to Arbitrate

Even though California has a strong policy favoring arbitration, "[i]t is beyond cavil that arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." Ajida Tech., Inc., v. Roos Instruments, Inc., 87 Cal.App.4th 534, 541 (2001) (citations and internal quotation omitted). The Court must interpret the parties' written agreement so as to give effect to the parties' mutual intention. Ben-Zvi v. Edmar Co., 40 Cal.App.4th 468, 473 (1995); Floystrup v. City of Berkeley Rent Stabilization Bd., 219 Cal.App.3d 1309, 1317 (1990). If possible, the Court will determine the parties' intention solely from the language of the agreement itself. Ben-Zvi, 40 Cal.App.4th at 473. Extrinsic evidence is admissible, however, if the offered evidence is relevant to prove the meaning of ambiguous language and such interpretation is reasonable in light of all the facts, circumstances, and conditions surrounding the execution of the agreement. Oakland-Alameda

1 County Coliseum v. Oakland Raiders, Ltd., 197 Cal.App.3d 1049, 1057-58 (1988). “Because the
2 existence of the agreement is a statutory prerequisite to granting the petition, the petitioner bears
3 the burden of proving its existence by a preponderance of the evidence.” Rosenthal v. Great W.
4 Fin. Securities Corp., 14 Cal.4th 394, 413 (1996).

5 It is undisputed that Comb’s claims are not subject to arbitration. With respect to Toher
6 and Resnick, PayPal failed to submit with its original moving papers copies of the agreements
7 into which Toher and Resnick allegedly entered, arguing that circumstantial evidence sufficiently
8 demonstrates assent by these Plaintiffs to the User Agreement PayPal currently offers its new
9 customers. At oral argument, PayPal reiterated its claim that Resnick entered into an agreement
10 containing the exact arbitration clause found in Section II (19) of the current User Agreement,
11 but it conceded that the version of the User Agreement entered into by Toher did not contain the
12 subject arbitration clause. PayPal nonetheless argued that Toher is bound to the *current* User
13 Agreement, including the arbitration clause, because the version of the User Agreement Toher
14 did accept binds her to any subsequent revisions to the User Agreement. After the hearing,
15 PayPal submitted supplemental declarations and exhibits (“the Supplemental Material”) from
16 PayPal’s Senior Manager for Online Communications and Marketing Damon Billian.⁸ The
17 Supplemental Material provides an electronic record of the dates Toher and Resnick opened their
18 respective accounts, a copy of the version of the User Agreement PayPal claims was in effect at
19 the time the respective accounts were opened, and copies of five subsequent versions of the User
20 Agreement.

21 Although an electronic record constitutes sufficient evidence that the parties have entered

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23 ⁸ Plaintiffs object strenuously to the Court’s consideration of the Supplemental Material.
24 They argue that PayPal filed these documents in violation of this Court’s Local Rules, and that
25 the documents demonstrate that PayPal’s original claim that Toher agreed to arbitration was
26 false. The Court agrees that the filing did not comply with the Local Rules, and one reasonably
27 may infer from the circumstances that PayPal’s counsel at the very least were negligent in their
28 original representations to the Court. The Court does not take such irregularities lightly and will
not hesitate to impose sanctions should this situation arise again. Nonetheless, because it
concludes that the interests of justice are best served by reaching Plaintiffs’ unconscionability
arguments, the Court has given counsel the benefit of the doubt and has considered the
Supplemental Material.

1 into a binding agreement, the applicable statutes require production of *a record* that the parties
2 have entered into an agreement and evidence of the terms and conditions contained in such
3 agreement. Plaintiffs argue that the Supplemental Material contains no evidence of any
4 electronic or actual record of Plaintiffs’ assent to the purported agreements. The Court agrees
5 that PayPal has made a weak showing, but for purposes of the instant motion, it will assume
6 without deciding that the circumstantial evidence is sufficient to demonstrate that Toher and
7 Resnick entered into agreements with PayPal.⁹

8 **B. Unconscionability**

9 Plaintiffs argue that even if they did enter into a version of the User Agreement, the User
10 Agreement and in particular its arbitration clause are unconscionable. Unconscionability is a
11 defense applicable to contracts generally and thus may be raised in defense to an arbitration
12 provision. Blake v. Ecker, 93 Cal.App.4th 728, 741 (2001). Unconscionability has both
13 procedural and substantive components. Id. at 742. The procedural component is satisfied by the
14 existence of unequal bargaining positions and hidden terms common in the context of adhesion
15 contracts. Id. The substantive component is satisfied by overly harsh or one-sided results that
16 “shock the conscience.” Id. The two elements operate on a sliding scale such that the more
17 significant one is, the less significant the other need be. Id. at 743. A claim of unconscionability
18 cannot be determined merely by examining the face of the contract; there must be an inquiry into
19 the circumstances under which the contract was executed, its purpose, and effect. Id.

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25 ⁹ PayPal argues that because the User Agreement entered into by Toher provides that “this
26 Agreement is subject to change at any time without notice,” she assented to the arbitration clause
27 that PayPal inserted into a subsequent version of the User Agreement. In light of the disposition
28 of the motion, the Court need not decide whether such a provision ever could result in a binding
agreement to arbitrate. As discussed below, however, PayPal’s unilateral and apparently
unfettered right to revise the User Agreement does bear on the question of whether the User
Agreement is substantively unconscionable.

1 **1. Procedural Unconscionability**

2 A contract or clause is procedurally unconscionable if it is a contract of adhesion. Flores
3 v. Transamerica HomeFirst, Inc., 93 Cal.App.4th 846, 853 (2001). A contract of adhesion, in
4 turn, is a “standardized contract, which, imposed and drafted by the party of superior bargaining
5 strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject
6 it.” Armendariz v. Foundation Health Psychcare Serv., 24 Cal.4th 83, 113 (2000) (citations and
7 internal quotation omitted). Although PayPal does not dispute that the agreement and arbitration
8 clause at issue here meet this definition, it asserts that the instant contract is not procedurally
9 unconscionable because it does not concern essential items such as food or clothing and because
10 Plaintiffs had meaningful alternative sources for the subject services.

11 Relying upon Dean Witter Reynolds, Inc. v. Superior Court, 211 Cal.App.3d 758, 769
12 (1989), PayPal argues that the availability of alternative sources is enough to defeat a showing of
13 procedural unconscionability. In Dean Witter, however, the California Court of Appeal noted
14 that the party asserting unconscionability was “a sophisticated investor” and that “[t]he record
15 establishe[d] without conflict that other financial institutions offered competing IRA’s which
16 lacked the challenged provision.” Id. at 771. In this case, the amount of the average transaction
17 is \$55.00, the vast majority of PayPal customers are private individuals who are not
18 “sophisticated,” and there is at least a factual dispute as to whether PayPal’s competitors offer
19 their services without requiring customers to enter into arbitration agreements.¹⁰ The Dean
20 Witter court explicitly limited its holding, indicating that a claim of procedural unconscionability
21 cannot be defeated merely by “any showing of competition in the marketplace as to the desired
22 goods and services. . . .” Id. at 772 (emphasis in original). PayPal cites no authority extending
23 Dean Witter to circumstances analogous to those presented here. Cf. Armendariz, 24 Cal.4th at
24 113 (rejecting argument that contract between employer and employee was not adhesive because
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26 ¹⁰ The record also demonstrates that individuals who are not account holders must register
27 with the service as a precondition to accessing funds that an account holder sends to them.
28 Although none of the named Plaintiffs opened an account by such means, the Court notes that
such individuals would not have any meaningful alternatives available to them.

1 employer demonstrated existence of alternative sources of employment that were not conditioned
2 on the acceptance of an arbitration clause). See also, Szetela v. Discover Bank, 97 Cal.App.4th
3 1094, 1100 (2002) (finding availability of substitute goods not "the relevant test for
4 unconscionability" in dispute between unsophisticated consumer and large financial institution).
5 The Court concludes that the User Agreement at issue here satisfies the criteria for procedural
6 unconscionability under California law.

7 **2. Substantive Unconscionability**

8 Even if instant agreement is procedurally unconscionable, it may nonetheless be
9 enforceable if the substantive terms are reasonable. See Craig v. Brown & Root, Inc., 84
10 Cal.App.4th 416, 422-23 (2000) (finding contract of adhesion to arbitrate disputes enforceable).
11 The Court's principal substantive concerns in the present case are a lack of mutuality in the User
12 Agreement and the practical effects of the arbitration clause with respect to consolidation of
13 claims, the costs of arbitration, and venue.

14 **a. Mutuality**

15 Substantive unconscionability has been found in many cases based upon arbitration
16 provisions requiring arbitration of the weaker party's claims but permitting a choice of forums
17 for the stronger party. See, e.g., Ticknor, 265 F.3d at 940-41; Mercuro v. Superior Court, 96
18 Cal.App.4th 167, 176 (2002). Considered in isolation, the arbitration clause at issue here appears
19 to permit a mutuality of remedies, providing that "[e]ither you or PayPal may seek any interim or
20 preliminary relief from a court of competent jurisdiction in Santa Clara County, California
21 necessary to protect the rights or property of you or PayPal, Inc. (or its agents, suppliers, and
22 subcontractors) pending the completion of arbitration." User Agreement, Section II (19).
23 Section V(3) of the User Agreement, however, provides that in the event of a dispute, PayPal "at
24 its sole discretion" may restrict accounts, withhold funds, undertake its own investigation of a
25 customer's financial records, close accounts, and procure ownership of all funds in dispute unless
26 and until the customer is "later determined to be entitled to the funds in dispute." PayPal alone
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1 makes the final decision with respect to a dispute.¹¹ Finally, as noted earlier, the User Agreement
2 “is subject to change by PayPal without prior notice (unless prior notice is required by law), by
3 posting of the revised Agreement on the PayPal website.”¹²

4 A contract may provide a “margin of safety” that provides the party with superior
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6 ¹¹ Section V(3) provides:

7 PayPal, at its sole discretion, reserves the right to close an account at any time for
8 any reason, including but not limited to a violation of this Agreement, upon notice
9 to the User and payment to the User of any unrestricted funds held in custody.
10 PayPal, at its sole discretion, also reserves the right to periodically retrieve and
11 review a business and / or consumer credit report for any account, and reserves the
right to close an account based on information obtained during this credit review
process.

12 PayPal, at its sole discretion, also reserves the right to restrict withdrawals from an
13 account for any one of the events listed below. If the dispute covers only a specific
14 transaction, we will only restrict funds related to that particular transaction. If your
15 account is restricted, you will be notified by e-mail and requested to provide
16 information relevant to your account. PayPal will investigate the matter promptly.
17 If the investigation is in your favor, we will unrestrict your account. If the
18 investigation is not in your favor, PayPal may return funds to the sender and
19 unrestrict the remainder of your account, continue the restriction for up to 180
20 days as to funds necessary to protect PayPal against the risk of reversals, or may
21 close your account by giving you notice and mailing a check for any funds in your
22 account (minus funds that are in dispute) to the address that you have provided. If
23 you are later determined to be entitled to the funds in dispute, PayPal will make an
additional payment of those funds to you. Any of the following events may lead to
a restriction of your account . . . [omitting list of nineteen provisions that include
“Receipt of potentially fraudulent funds,” “Refusal to cooperate in an
investigation,” “Opening multiple Personal accounts,” and “Logging in from a
country not included on PayPal’s permitted countries list.”]. . . [¶] PayPal will use
reasonable efforts to investigate accounts that are subject to a restriction and to
reach a final decision promptly.

24 ¹² ¶ 2 provides:

25 This Agreement is subject to change by PayPal without prior notice (unless prior
26 notice is required by law), by posting of the revised Agreement on the PayPal
27 website. Descriptions of material amendments to this Agreement will be posted in
advance on the PayPal website in the "Policy Updates" section that is displayed to
you when you log in to your account. You can also set your Preferences to receive
e-mail notification of all policy updates. You may review the current Agreement
28 prior to initiating a transaction at any time at our User Agreement page.

1 bargaining strength protection for which it has a legitimate commercial need. “However, unless
2 the ‘business realities’ that create the special need for such an advantage are explained in the
3 contract itself, . . . it must be factually established.” Stirlen v. Supercuts, Inc., 51 Cal.App.4th
4 1519, 1536 (1997). When a contract is alleged to be unconscionable, “the parties shall be
5 afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and
6 effect to aid the court in making the determination.” Cal. Civ. Code § 1670.5. The statutory
7 scheme reflects “legislative recognition that a claim of unconscionability often cannot be
8 determined merely by examining the face of the contract, but will require inquiry into its setting,
9 purpose, and effect.” Stirlen, 51 Cal.App.4th at 1536 (citations and internal quotations omitted).

10 PayPal argues that the User Agreement does not lack mutuality because nothing in the
11 agreement precludes a customer from using the court system to seek any relief related to a
12 restricted account pending the outcome of an arbitration proceeding. However, Plaintiffs present
13 evidence that PayPal has frozen customer accounts and retained funds that it alone determined
14 were subject to dispute without notice to the named Plaintiffs. The User Agreement expressly
15 authorizes PayPal to engage in such conduct unilaterally. While in theory a customer may seek
16 provisional relief in the courts, including presumably an order to unfreeze an account, the cost of
17 doing so would be prohibitive in relation to the amounts typically in dispute. For all practical
18 purposes, a customer may resolve disputes only after PayPal has had control of the disputed
19 funds for an indefinite period of time. Although PayPal alone may amend the User Agreement
20 without notice or negotiation, a customer is bound to any and all such amendments for the
21 duration of the customer’s relationship with PayPal. PayPal has not shown that “business
22 realities” justify such one-sidedness. See, e.g., Flores, 93 Cal.App.4th at 854 (finding lack of
23 mutuality when debtor must arbitrate any controversy arising out of a loan whereas the lender
24 may proceed by judicial or nonjudicial foreclosure, by self-help remedies such as setoff, and by
25 injunctive relief to obtain appointment of a receiver); Stirlin, 51 Cal.App.4th at 1540 (finding
26 that a mandatory arbitration requirement realistically applies “primarily if not exclusively” to
27 claims filed by the employer in light of employer’s failure to identify any provision of the
28 contract or statute likely to give rise to a claim to which it would be compelled to submit to

1 arbitration).

2 **b. Prohibition against Consolidation of Claims**

3 The subject arbitration clause expressly prohibits PayPal customers from consolidating
4 their claims. Relying upon Vernon v. Drexel Burnham & Co., 52 Cal.App.3d 706, 716 (1975),
5 PayPal argues that such a prohibition cannot render an agreement to arbitrate substantively
6 unconscionable. The arbitration clause in Vernon, however, did not preclude consolidation of
7 claims *per se*, and whatever relevance Vernon may have in this case is overshadowed by the
8 much more recent decision of the California Court of Appeal in Szetela v Discover Bank, 97
9 Cal.App.4th at 1094. As is this case here, the arbitration agreement at issue in Szetela
10 categorically prohibited individual customers from joining or consolidating claims in arbitration.
11 The court determined that a large credit card company could not enforce the prohibition with
12 respect to consumer claims against it because in practice most claims likely would involve
13 consumers seeking the return of small amounts of money, and any remedy obtained by the few
14 consumers who would not be dissuaded from pursuing their rights would pertain only to those
15 consumers without collateral estoppel effect. Id. at 1101. The court concluded that such
16 circumstances raise “[t]he potential for millions of customers to be overcharged small amounts
17 without an effective method of redress. . . .” Id.

18 PayPal argues that because federal cases applying the FAA have enforced arbitration
19 clauses containing such prohibitions on collective actions,¹³ Szetela is irrelevant to the present
20 proceedings. In the Ninth Circuit, however, while the FAA preempts any legislation “specifically
21 aimed at arbitration agreements,” “[i]n all situations where arbitration provisions are placed on
22 the same footing as other contracts, state law applies.” Ticknor, 265 F.3d at 941 (citation and
23 internal quotation omitted). Thus, while California’s consumer protection statutes cannot
24 prevent enforcement under the FAA of a prohibition on collective actions as such, a federal court
25 properly may consider whether such a prohibition in combination with other provisions and
26 circumstances renders an agreement substantively unconscionable as a matter of state law.

27
28 ¹³ See, e.g., Champ v. Siegel Trading Co., 55 F.3d 269, 274-75 (7th Cir. 1995); Gilmer v.
Interstate/Johnson Lane Corp., 500 U.S. 20, 32 (1991).

1 **c. Costs of Arbitration**

2 Plaintiffs claim that the cost of an individual arbitration under the User Agreement is
3 likely to exceed \$5,000 and submit declarations stating that such arbitration would be cost-
4 prohibitive for them.¹⁴ PayPal disputes Plaintiffs' calculation of costs, contending that because
5 any arbitration in practice would proceed under the consumer rules of the American Arbitration
6 Association ("AAA"), a customer's only expense would be a filing fee of approximately
7 \$125.00.

8 The arbitration clause itself expressly undercuts PayPal's assertion. It states in pertinent
9 part that "[a]ny controversy or claim arising out of or relating to this Agreement or the provision
10 of Services shall be settled by binding arbitration in accordance with the *commercial* arbitration
11 rules of the American Arbitration Association." (emphasis added).¹⁵ Further, because the clause
12 is silent as to who bears the cost of arbitration, under California law each party is required to pay
13 a *pro rata* share of the "expenses and fees of the neutral arbitrator, together with other expenses
14 of the arbitration incurred or approved by the neutral arbitrator, not including counsel fees or
15 witness fees or other expenses incurred by a party for his own benefit." Cal. Code Civ. P. §
16 1284.2.

17 Unlike the plaintiff in Green Tree Fin. Corp.-Ala. v. Randolph, 531 U.S. 79 (2000) who
18 claimed that the unknown and unidentified risk of excessive fees should be sufficient to defeat a
19 valid arbitration clause, the named Plaintiffs here, none of whose individual claims exceeds
20 \$310.00, have shown that the costs each of them is likely to incur in commercial arbitration
21 likely would exceed those involved in bringing a collective action. By allowing for prohibitive
22 arbitration fees and precluding joinder of claims (which would make each individual customer's
23

24 ¹⁴ PayPal objects to the declaration of Ann Saponora as exceeding the page limitations
25 applicable to Plaintiffs' opposing papers and object to various portions of the declaration as
26 vague and ambiguous, irrelevant, lacking foundation, hearsay, improper opinion, conclusion,
27 speculation, violating the Best Evidence Rule, and improper use of case law and argument in a
28 declaration. The objections are overruled. See also, supra, n.2.

¹⁵ The AAA rules, offered in evidence by PayPal at oral argument, plainly contain distinct
procedures for "commercial" and "consumer" arbitrations.

1 participation in arbitration more economical), PayPal appears to be attempting to insulate itself
2 contractually from any meaningful challenge to its alleged practices. Under these circumstances,
3 the Court concludes that this aspect of the arbitration clause is so harsh as to be substantively
4 unconscionable. See, e.g., Armendariz, 24 Cal.4th at 113.

5 **d. Venue**

6 The User Agreement requires that any arbitration take place in Santa Clara County,
7 California. PayPal argues that this venue provision is not unconscionable because forum
8 selection clauses in general are *prima facie* valid, courts have found similar forum selection
9 clauses in arbitration clauses reasonable, and the named Plaintiffs themselves elected to litigate
10 in this Court, thereby undercutting any claim that the contractual forum is burdensome or
11 inconvenient for them.

12 Although it is true that forum selection clauses generally are presumed *prima facie* valid,
13 a forum selection clause may be unconscionable if the "place or manner" in which arbitration is
14 to occur is unreasonable taking into account "the respective circumstances of the parties." Bolter
15 v. Superior Court, 87 Cal.App.4th 900, 909 (2001). The record in this case shows that PayPal
16 serves millions of customers across the United States and that the amount of the average
17 transaction through PayPal is \$55.00. Although PayPal cites to unpublished or out-of-state
18 authority holding that such facts do not warrant a finding of unconscionability, PayPal cites no
19 California authority holding that it is reasonable for individual consumers from throughout the
20 country to travel to one locale to arbitrate claims involving such minimal sums. Limiting venue
21 to PayPal's backyard appears to be yet one more means by which the arbitration clause serves to
22 shield PayPal from liability instead of providing a neutral forum in which to arbitrate disputes.¹⁶
23 See, e.g., Bolter, 87 Cal.App.4th at 909 (finding that enforcement of forum selection clause
24 providing that claims are arbitrated exclusively in Utah would be cost prohibitive in light of fact
25 that the potential claimants located around the country would be required to retain counsel

26
27 ¹⁶ As it does with respect to the costs of arbitration, PayPal contends that the AAA
28 consumer rules mitigate any unfairness by permitting telephonic participation in arbitration
hearings. As already discussed, however, the User Agreement on its face provides that the AAA
commercial rules apply.

familiar with Utah law).¹⁷

III. DISPOSITION

Having considered the terms of the User Agreement generally and the arbitration clause in particular, as well as the totality of the circumstances, the Court concludes that the User Agreement and arbitration clause are substantively unconscionable under California law and that arbitration cannot be compelled herein. Good cause therefor appearing, IT IS HEREBY ORDERED that the motions to compel individual arbitration are DENIED.

DATED: August 30, 2002

/s/ (electronic signature authorized)

JEREMY FOGEL
United States District Judge

¹⁷ Plaintiffs also contend that the subject arbitration clause is unconscionable because it requires them to waive statutory rights. The Court does not find this contention persuasive, and in any event it need not reach it.

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